Office - Supreme Court, U. S.
FILED
MAY 14 1945
CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1944.

No. 1265

CHAPMAN PRICE STEEL COMPANY, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF.

LOREN E. SOUERS,
ALBERT B. ARBAUGH,
Counsel for Petitioner,
1200 Harter Bank Building,
Canton 2, Ohio.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

INDEX.

	Page
PETITION	1
I. Basis of jurisdiction	1
II. Summary statement	2
III. Questions presented	3
IV. Reasons relied upon for allowance	4
BRIEF	5
I. Opinions below	5
II. Jurisdiction	5
III. Statement of case	6
IV. Questions presented	7
V. Statutes involved	7
VI. Argument	8
Conflict in decisions	8
Important Question of Federal tax law	9
Decision below is erroneous	9
Conclusion	12
APPENDIX	13
Section 201, Revenue Act of 1918	13
Section 27, Internal Revenue Code	14
Article 27(a) 2, Regulations 101	14

CITATIONS OF AUTHORITY.

CASES:

Commissioner vs. Quackenbos, 78 Fed. (2d) 156	8
De Nobili Cigar Co. vs. Commissioner, 143 Fed. (2d) 436	8
Eisner vs. Macomber, 252 U. S. 189	3, 7, 8, 11
Estate of Bedford vs. Commissioner, 144 Fed. (2d) 272; 1 T. C. 478	4, 6, 7, 8, 9

Page

Koshland vs. Helvering, 298 U. S. 441..... 11
Miller vs. Robertson, 266 U. S. 243..... 11
Patty vs. Helvering, 98 Fed. (2d) 717..... 8, 9
Rose vs. Barclay, 191 Pa. St. 594..... 10
Sexton vs. Percival, 189 Ia. 586 9

STATUTES:

Section 201, Revenue Act of 1918..... 13
Section 27, Internal Revenue Code 14
Section 2, Revenue Act of 1916 11

REGULATIONS:

Article 27(a) 2, Regulations 101 14

IN THE

Supreme Court of the United States

OCTOBER TERM, 1944.

No. .....

CHAPMAN PRICE STEEL COMPANY, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

To the Honorable the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

The petitioner, Chapman Price Steel Company, respectfully shows:

I. Basis of Jurisdiction.

Jurisdiction of the Supreme Court of the United States is invoked under section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925; United States Code, Chapter 28, section 347. The judgment or decree, re-

view whereof is sought by the Petitioner, was entered by the Circuit Court of Appeals for the Seventh Circuit on December 15, 1944, said judgment or decree having affirmed an order of The Tax Court of the United States, which sustained an assessment against Petitioner of a deficiency in corporate income taxes by the Respondent Commissioner of Internal Revenue. The time for filing this petition for a writ of certiorari was extended to and including May 14, 1945 by an order duly made by an Associate Justice of the Supreme Court on March 1, 1945.

The Petitioner presents to this Court, and files herewith as an exhibit hereof, a duly certified transcript of the entire record in the case, as the same appears in the Circuit Court of Appeals for the Seventh Circuit, including the record of the proceedings in The Tax Court of the United States.

II. Summary Statement of the Matter Involved.

The Petitioner is, and was at the time of filing its corporate income tax return for the year 1939, a corporation organized under the laws of the state of Indiana which is in the Internal Revenue District of Indiana. It duly filed its corporate income tax return for said year with the United States Collector of Internal Revenue for the District of Indiana, and paid to the said Collector the tax shown by said return to be due.

The Respondent is the duly appointed, qualified and acting Commissioner of Internal Revenue of the United States, holding his office by virtue of the laws of the United States, and the controversy involved herein arises under the Internal Revenue Code.

On October 26, 1942 the deficiency notice was mailed, asserting a deficiency of $1,895.83, all of which resulted from Respondent's refusal to allow a dividends paid credit on account of a deficit in Petitioner's earned surplus account. This earned surplus deficit was directly caused by the charge to said earned surplus account, of a stock dividend authorized and distributed by Petitioner to its shareholders on

December 31, 1920. Said dividend was declared in common shares and was paid on common shares, there being but one class of stock outstanding.

The Respondent disallowed said deduction on the theory that said stock dividend did not constitute a distribution of earnings although the distribution had been made while Section 201 of the Revenue Act of 1918 (40 Stat. 1057) was in full force and effect. That section in substance provided that a dividend included any distribution by a corporation, whether in cash, or in other property or in stock of the distributing corporation, and further, that any distribution was deemed to have been made from earnings or profits unless all earnings and profits had first been distributed.

The Petitioner appealed to The Tax Court from Respondent's action and was there heard on a stipulation of facts. That Court upheld Respondent on the ground that the decision in *Eisner* v. *Macomber*, 252 U. S. 189, had held a stock dividend was not a taxable distribution and therefore the statutory provision of Section 201 defining dividend to include a stock dividend, also was voided by that decision.

The Circuit Court of Appeals for the Seventh Circuit affirmed The Tax Court decision on the same reasoning, and on the added ground that a stock dividend, after the *Eisner* v. *Macomber* decision, did not constitute a distribution, and therefore could not meet the test of Section 201 which required a dividend to be a "distribution".

III. Questions Presented.

(a) Did the declaration and distribution of the stock dividend on December 31, 1920 constitute a distribution of earnings?

(b) Did the decision in *Eisner* v. *Macomber* strike down the definition of "dividend" contained in Section 201 of the Revenue Act of 1918?

IV. Reasons Relied on for Allowance of the Writ.

1. The decision of said Circuit Court of Appeals for the Seventh Circuit, review whereof is sought by the Petitioner, is in conflict with a decision of the Circuit Court of Appeals for the Second Circuit, rendered in the case of *Estate of Edward T. Bedford* v. *Commissioner* (144 Fed. (2d) 272), decided by said last named Court on August 8, 1944, which is now awaiting decision by this Court, having been argued on March 29, 1945 as Docket No. 710.

2. Said Circuit Court of Appeals for the Seventh Circuit, by its decision decided an important question of Federal Tax law which has not been, but should be, settled by this Court.

3. The Petitioner believes that said decision of the Circuit Court of Appeals for the Seventh Circuit is contrary to law and the established principles of statutory construction.

V.

WHEREFORE, the Petitioner prays that a writ of certiorari issue under the seal of this Court, directed to the Circuit Court of Appeals for the Seventh Circuit, commanding said Court to certify and send to this Court a full and complete transcript of the record and of the proceedings of the said Circuit Court of Appeals, had in the case numbered and entitled on its docket as No. 8511, Chapman Price Steel Company, Petitioner, v. Commissioner of Internal Revenue, Respondent, to the end that this cause may be reviewed and determined by this Court as provided for by the statutes of the United States; and that said judgment or decree be reversed by this Court; and for such other relief as may seem proper.

CHAPMAN PRICE STEEL COMPANY,

By LOREN E. SOUERS,
ALBERT B. ARBAUGH,
Counsel for Petitioner.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1944.

No. .....

CHAPMAN PRICE STEEL COMPANY, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I. OPINIONS BELOW.

The opinion of the Circuit Court of Appeals for the Seventh Circuit (R. 44-48) is reported in 146 Fed. (2d) 189. The Memorandum Findings of Fact and Opinion of The Tax Court (R. 26-27) are not included in the official reports of that Court, but are unofficially reported as CCH Dec. 13,472 (M).

II. JURISDICTION.

Jurisdiction of the Supreme Court is invoked under Section 240(a) of the Judicial Code, as amended; (U. S. C. A. Chap. 28, Sec. 347). The decision of the Circuit Court of Appeals was rendered on December 15, 1944. The time for

filing the petition for writ of certiorari was extended to and including May 14, 1945 by order of an Associate Justice, entered March 1, 1945. The controversy involves corporate income taxes sought to be collected from the Petitioner under the provisions of the Revenue Act of 1938 (52 Stat. 447).

III. STATEMENT OF CASE.

The Petitioner, an Indiana corporation, duly filed its corporate income return with the Collector for the District of Indiana for the calendar year 1939. On this return, Petitioner took a "dividends paid credit" of $3718.46 under Section 27 of the Revenue Act of 1938 on account of a deficit in the accumulated earnings and profits existing as of the close of the preceding calendar year. This deficit was directly the result of the charge to said account on December 31, 1920 of a stock dividend declared and paid by Petitioner on that date in the amount of $240,456.00. This stock dividend was paid in common shares upon common shares, there being but the one class of stock outstanding (R. 18). Petitioner claimed the right to this deduction under the specific terms of said Section 27 of the Revenue Act of 1938, and under the provisions of Section 201 of the Revenue Act of 1918 (40 Stat. 1057) which latter section defined dividend distributions to include stock dividends and declared any such distribution should be deemed to be a distribution of earnings and profits. Petitioner also relies upon the decision of the Circuit Court of Appeals for the Second Circuit in *Estate of Bedford* v. *Commissioner*, 144 Fed. (2d) 272, and other decisions of said Circuit cited therein. The Respondent disallowed the "dividends paid credit" and issued a deficiency notice against Petitioner. An appeal was filed with The Tax Court and the cause there tried on a stipulation embodying all facts. It was therein agreed that if Petitioner was entitled to such a credit, the correct amount thereof would be $3,404.80 (R. 18). It was the Respondent's position before The Tax Court, and the Circuit Court

of Appeals as well, that the stock dividend did not distribute earnings, and when the amount thereof was restored to the earned surplus account, there was in fact no deficit therein and thus no "dividends paid credit" was allowable.

The Tax Court sustained the Respondent, upon the reasoning that the stock dividend did not distribute earnings, relying on the decision in *Eisner* v. *Macomber*, 252 U. S. 189, that stock dividends were not taxable income to the recipient shareholders, and upon The Tax Court's previous decision in *Estate of Bedford*, 1 T. C. 478.

Upon appeal to the Circuit Court of Appeals for the Seventh Circuit, the decision of The Tax Court was affirmed on the reasoning adopted by The Tax Court and upon the further ground (the Bedford decision of The Tax Court having been reversed) that *Eisner* v. *Macomber* struck down not only those portions of the Revenue Act of 1916 which attempted to tax stock dividends as income, but also the further provision of the 1918 Act which defined dividends to include distribution of stock dividends.

IV. QUESTIONS PRESENTED.

(a) Did the declaration and distribution of the stock dividend on December 31, 1920 constitute a distribution of earnings?

(b) Did the decision in *Eisner* v. *Macomber* strike down the definition of "dividend" set out in Section 201 of the Revenue Act of 1918?

V. STATUTES INVOLVED.

The pertinent provisions of Section 201 of the Revenue Act of 1918 and Section 27 of the Internal Revenue Code (a part of the Revenue Act of 1938), and of Article 27 (a) 2 of Regulations 101 are set out in full in the Appendix of this brief.

VI. ARGUMENT.

A. The decision below is in conflict with the decision of the Second Circuit Court of Appeals.

B. This cause involves an important question of Federal tax law, which should be settled by this Court.

C. The conclusions of the Courts below are erroneous and contrary to the established principles of statutory construction.

Conflict in Decisions.

At the very outset, counsel for Petitioner state they do not attack nor do they seek to re-argue the conclusion reached by this Court in *Eisner* v. *Macomber*, 252 U. S. 189, viz: that stock dividends are not taxable income to the shareholder recipients. It is the position of counsel that the Eisner decision never considered or passed on those portions of Section 201 of the Revenue Act of 1918 which are pertinent and decisive of the issues herein.

The decision of the court below in this cause is in direct conflict with decisions of the Circuit Court of Appeals for the Second Circuit in *Estate of Bedford* v. *Commissioner*, 144 Fed. (2d) 272; *Commissioner* v. *Quackenbos*, 78 Fed. (2d) 156; *Patty* v. *Helvering*, 98 Fed. (2d) 717; and *DeNobili Cigar Co.* v. *Commissioner*, 143 Fed. (2d) 436. This is clearly evident from the following quotation from the Bedford decision (p. 273).

> "We held in Commissioner vs. Quackenbos, 78 F. (2d) 156; Patty vs. Helvering, 98 F. (2d) 717; and DeNobili Cigar Co. vs. Commissioner, 143 F. (2d) 436, that when earnings are once capitalized by the issue of stock dividends they are no longer earnings but capital, except in cases where the purpose of the transaction is not an honest business purpose but one to avoid taxation."

A more extensive discussion appears in the Opinion in *Patty* v. *Helvering, supra.*

Important Question of Federal Tax Law.

While the question in this cause arises under the Revenue Act of 1918, the decision deals with a principle of taxation which is still very important to all corporate taxpayers who declared and paid stock dividends during the period from February 24, 1919 to November 23, 1921, while that Act was in effect. The language in Section 201 of this Act was eliminated by the Revenue Act of 1921 (42 Stat. 227) and has not appeared in any subsequent Act. The question also has arisen and will arise in many cases involving liquidation as was true in *Patty* v. *Helvering, supra,* and in cases where it is necessary to distinguish between the payment of a dividend and a distribution in partial liquidation. Cf. *Estate of Bedford* v. *Commissioner, supra.*

Decision Below is Erroneous.

The vital and important fact is that the stock dividend in question was made a distribution of earnings by Section 201 of the Revenue Act of 1918, quoted in full in the Appendix to this Brief. We paraphrase the material words of subsection (a): dividend means any distribution made by a corporation, whether in cash or in other property or in stock of the corporation; also of subsection (b): any distribution shall be deemed to have been made from earnings or profits unless all earnings and profits have already been distributed.

This statutory declaration follows the established rule of corporate law.

> "Earnings of a corporation remain such until the intent to make them a part of the permanent property of the corporation is in some way manifest.
>
> "Earnings may be divided in two ways: (1) by declaring and paying a cash dividend; or (2) by declaring and issuing a stock dividend."
>
> *Sexton* v. *Percival,* 189 Ia. 586 (Par. 3 and 4 of Syl.).

> "A dividend is that portion of the profits and surplus funds of a corporation which has actually been set apart by a valid resolution of the Board of Directors, or by the shareholders at a corporate meeting for distribution among the shareholders according to their respective interests in such a sense as to become segregated from the property of the shareholders distributably. It is a matter of no difference whether the dividend is declared in stock or paid in cash and thereafter converted into stock by the shareholders; in either event it is a distribution of the surplus profits of the corporation."
>
> *Rose* v. *Barclay*, 191 Pa. St., 594 (Syl.).

Nor does Section 27 of the Internal Revenue Code, or Regulations issued by Respondent interpreting the same, exclude stock dividends from the determination of a deficit in accumulated earnings and profits for purposes of a "dividends paid credit". (See Appendix.) This credit is composed of (a) the basic surtax credit, (b) the dividend carry over, (c) any deficit in accumulated earnings and profits, and (d) amounts used or set aside to pay or retire indebtedness. The word "deficit" is used in this section without definition or limitation, while other subsections specifically define and fix methods of computation for (a) and (b). It is important that in defining "basic surtax credit" subsection (i) provides:

> "(i) Nontaxable Distributions. If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, such part shall not be included in computing the basic surtax credit."

The Respondent in Regulations 101, Article 27(a)2 places no limitation upon the method by which the deficit in earned surplus account arises. We quote only the material portions:

"Included in the dividends paid credit is an amount equal to the excess of any deficit in accumulated earnings and profits * * * *.

"A deficit in accumulated earnings and profits can arise only out of the operation of the business at a loss and cannot be caused by distributions to shareholders in excess of the amount of accumulated earnings and profits. If distributions are made to shareholders out of accumulated earnings and profits, however, such distributions may contribute to the creation of a deficit by so exhausting the accumulated earnings and profits that they are incapable of absorbing a loss thereafter resulting from the business."

Nowhere is the taxability of the distribution made the test of inclusion or exclusion in computations of a "deficit in accumulated earnings or profits".

Nor is the decision in *Eisner* v. *Macomber, supra,* to the contrary. Section 2 of the Revenue Act of 1916 was before this Court in that case. The 1916 Act contained no provision similar or in any way analagous to subsections (a) and (b) of the 1918 Act. The decision in that case held the distribution of a stock dividend did not constitute income within the 16th Amendment to the Constitution even though Section 2 of the 1916 Act declared such distributions to be taxable income. We point out that the question in the present cause is not taxability but the legislative grant of a credit to reduce taxable income. Credits and exemptions are always a matter of legislative grace. Thus when no limitation upon or method of computation of the deficit in accumulated earnings and profits is prescribed either in Section 27 or the Regulations pertaining thereto, it is submitted the term "deficit" is to be given its natural, plain, ordinary, and commonly understood meaning. *Miller* v. *Robertson,* 266 U. S. 243. The term "deficit" is unambiguous and any attempt by Respondent to enlarge the same by Regulation would be beyond his power. *Koshland* v. *Helvering,* 298 U. S. 441.

CONCLUSION.

It is therefore respectfully submitted that this cause is one calling for the exercise by this Court of its supervisory powers of review, and a writ of certiorari should be granted as prayed for.

LOREN E. SOUERS,
ALBERT B. ARBAUGH,
Counsel for Petitioner,
1200 Harter Bank Building,
Canton 2, Ohio.
Counsel for Petitioner.

APPENDIX.

Section 201, Revenue Act of 1918 (40 Stat. 1057)

"Sec. 201. (a) That the term 'dividend' when used in this title (except in paragraph (10) of subdivision (a) of section 234) means (1) any distribution made by a corporation, other than a personal service corporation, to its shareholders or members, whether in cash or in other property or in stock of the corporation, out of its earnings or profits accumulated since February 28, 1913, or (2) any such distribution made by a personal service corporation out of its earnings or profits accumulated since February 28, 1913, and prior to January 1, 1918.

"(b) Any distribution shall be deemed to have been made from earnings or profits unless all earnings and profits have first been distributed. Any distribution made in the year 1918 or any year thereafter shall be deemed to have been made from earnings or profits accumulated since February 28, 1913, or, in the case of a personal service corporation, from the most recently accumulated earnings or profits; but any earnings or profits accumulated prior to March 1, 1913, may be distributed in stock dividends or otherwise, exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed.

"(c) A dividend paid in stock of the corporation shall be considered income to the amount of the earnings or profits distributed. Amounts distributed in the liquidation of a corporation shall be treated as payments in exchange for stock or shares, and any gain or profit realized thereby shall be taxes to the distributee as other gains or profits.

"(d) If any stock dividend (1) is received by a taxpayer between January 1 and November 1, 1918, both dates inclusive, or (2) is during such period bona fide authorized or declared, and entered on the books of the corporation, and is received by a taxpayer after November 1, 1918, and before the expiration of thirty days after the passage of this Act, then such dividend shall, in the manner provided in section 206, be taxed to the recipient at the rates prescribed by law for the

years in which the corporation accumulated the earnings or profits from which such dividend was paid, but the dividend shall be deemed to have been paid from the most recently accumulated earnings or profits."

Section 27, Internal Revenue Code

"Sec. 27. (a) Definition in general.—As used in this title with respect to any taxable year the term 'dividends paid credit' means the sum of:

(1) The basic surtax credit for such year, computed as provided in subsection (b):

(2) the dividend carry-over to such year, computed as provided in subsection (c):

(3) The amount, if any, by which any deficit in the accumulated earnings and profits, as of the close of the preceding taxable year (whether beginning on, before, or after January 1, 1938), exceeds the amount of the credit provided in section 26 (c) (relating to net operating losses), for such preceding taxable year (if beginning after December 31, 1937);

* * * * * * * * *

"(f) Taxable stock dividends.—In case of a stock dividend or stock right which is a taxable dividend in the hands of shareholders under section 115 (f), the amount with respect thereto which shall be used in computing the basic surtax credit shall be the fair market value of the stock or the stock right at the time of the payment."

* * * * * * * * *

"(i) Nontaxable distribution.—If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, such part shall not be included in computing the basic surtax credit."

Section 27 (a)-2 Regulations 101

"Deficit credit.—Included in the dividends paid credit is an amount equal to the excess of any deficit in accumulated earnings and profits as of the close of the

preceding taxable year (whether beginning on, before, or after January 1, 1938) over the net operating loss credit allowed by section 26(c) for such preceding taxable year (if beginning after December 31, 1937). The full amount of such deficit is includible in computing the dividends paid credit for the first taxable year beginning after December 31, 1937, since no net operating loss credit will be available until the second taxable year subject to the Act.

"A deficit in accumulated earnings and profits can arise only out of the operation of the business at a loss and cannot be caused by distributions to shareholders in excess of the amount of accumulated earnings and profits. If distributions are made to shareholders out of accumulated earnings and profits, however, such distributions may contribute to the creation of a deficit by so exhausting the accumulated earnings and profits that they are incapable of absorbing a loss thereafter resulting from the business. It is the subsequent operating loss, however, and not the distribution which creates the deficit. For example, the X Corporation, which makes its income tax returns on the calendar year basis, has on January 1, 1938, accumulated earnings and profits of $100,000. During 1938 there are no further earnings and profits. On February 1, 1938, operating losses have reduced the accumulated earnings and profits account to $50,000. On March 1, 1938, $90,000 is distributed to shareholders. On April 1, 1938, an operating loss of $40,000 is incurred. There is no further change during the taxable year. Though the corporation closes its year with total assets of $180,000 less than it had on January 1, 1938, and $90,000 of that amount was attributable to operating losses, only $40,000 constitutes a deficit in accumulated earnings and profits as of the close of the year. If, however, no operating losses were incurred up to February 1, $90,000 was distributed to shareholders on February 1, a $50,000 operating loss was incurred on March 1, and a $40,000 operating loss on April 1, the corporation's deficit in accumulated earnings and profits would be $80,000 as of the close of the year.

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute and regulations involved	2
Statement	2
Argument	3
Conclusion	5
Appendix	6

CITATIONS

Cases:	
Bedford's Estate v. *Commissioner*, 144 F. 2d 272	5
Century Electric Co. v. *Commissioner*, 144 F. 2d 983, rehearing denied October 23, 1944	4
Commissioner v. *Estate of Bedford*, No. 710, October Term, 1944, decided May 21, 1945	5
Eisner v. *Macomber*, 252 U. S. 189	4
Helvering v. *Griffiths*, 318 U. S. 371	4
Van Norman Co. v. *Welch*, 141 F. 2d 99	5
Statute:	
Internal Revenue Code:	
Sec. 22 (26 U. S. C., Sec. 22)	6
Sec. 27 (26 U. S. C., Sec. 27)	6
Sec. 115 (26 U. S. C., Sec. 115)	6
Miscellaneous:	
S. Rep. No. 2156, 74th Cong., 2d sess., p. 19	4
Treasury Regulations 103:	
Sec. 19.27 (a)–1	7
Sec. 19.27 (a)–2	7
Sec. 19.115–11	8

In the Supreme Court of the United States

OCTOBER TERM, 1944

No. 1265

CHAPMAN PRICE STEEL COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 26–27) are unreported. The opinion of the Circuit Court of Appeals (R. 44–48) is reported in 146 F. 2d 189.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 15, 1944 (R. 49). By order of this Court entered on March 1, 1945, the time for filing a petition for certiorari was extended to and including May 14, 1945. The petition for a writ of certiorari was filed on May 14, 1945. The jurisdic-

tion of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Did a stock dividend of common on common stock, declared and paid December 31, 1920, constitute a distribution of earnings and profits, in view of Section 115 (h) of the Internal Revenue Code, so that operating losses thereafter sustained created a deficit in the accumulated earnings and profits at the close of the year 1938, which entitled the taxpayer to a deficit credit for the year 1939 under Section 27 (a) ( ) of the Code?

STATUTE AND REGULATIONS INVOLVED

The applicable provisions of the Internal Revenue Code and Treasury Regulations involved are set out in the Appendix, *infra*, pp. 6–8.

STATEMENT

The facts as stipulated with exhibits (R. 17–25) and as found by the Tax Court (R.26) may be summarized as follows:

The taxpayer is an Indiana corporation with its principal place of business in Indianapolis, Indiana (R. 17, 26). Its books were kept on the accrual basis and, as of the close of the year 1938, showed a deficit in the earned surplus account, the correct amount of which, as adjusted by the Commissioner, was $136,-192.18. The deficit shown on the books in the earned surplus account was directly caused by the charge to

the earned surplus account of a stock dividend in the amount of $240,456, authorized and distributed to shareholders on December 31, 1920. (R. 18, 26.)

The stock dividend was declared and distributed in common stock of the taxpayer and at the time of its declaration and distribution there was only one class of stock—common stock—of the taxpayer outstanding. Before the distribution of this stock dividend the taxpayer had earnings and profits accumulated after February 28, 1913,[1] in excess of the amount of $240,456. (R. 18, 26.)

In its income tax return for the year 1939, the taxpayer deducted as a deficit credit $3,718.46, based on a claimed deficit in its accumulated earnings and profits as of the close of the year 1938 (R. 17). The Commissioner determined that there was no deficit in the accumulated earnings and profits as of the close of the taxable year 1938 within the purview of the Internal Revenue Code and Treasury Regulations promulgated thereunder. He disallowed the claimed credit (R. 6). The Tax Court (R. 26–27) and the Circuit Court of Appeals for the Seventh Circuit (R. 49) affirmed that action.

ARGUMENT

The question here is not whether a stock dividend was a distribution of earnings under Section 201 of the Revenue Act of 1918 (Pet. 13–14). Rather, the question is whether in applying Section 27 (a) (3) of

[1] See Section 201 of the Revenue Act of 1918 (Pet. 13–14).

the Internal Revenue Code (Appendix *infra*, p. 6), the phrase "deficit in the accumulated earnings and profits" contemplates a deficit created by a stock dividend paid in 1920.

The answer is found in another provision of the Code which taxpayer fails to mention. Section 115 (h) (Appendix, *infra*, pp. 6–7) provides that no stock dividend, whether paid before or after January 1, 1939, shall be considered a distribution of earnings or profits if (1) no gain was recognized by the applicable law or (2) the distribution was not constitutionally subject to tax. Since *Eisner* v. *Macomber*, 252 U. S. 189, held that such a stock dividend as is here involved was not constitutionally subject to tax, and since Congress has subsequently given effect to that decision in its revenue legislation (*Helvering* v. *Griffiths*, 318 U. S. 371), it must follow from Section 115 (h) that taxpayer's surplus earnings as of 1920 were not distributed to its stockholders by the stock dividend paid in that year. See S. Rep. No. 2156, 74th Cong., 2d sess., p. 19. If the surplus was not distributed by reason of the 1920 stock dividend, it is clear that there was no deficit within the meaning of Section 27 (a) (3), for it is stipulated (R. 18) that the deficit upon which the taxpayer relies "was directly caused by the charge to said earned surplus account" by reason of the 1920 stock dividend.

The taxpayer does not deny that the construction of Section 115 (h) by other Circuit Courts of Appeals is in accord with that of the court below in the instant case. *Century Electric Co.* v. *Commissioner*,

144 F. 2d 983 (C. C. A. 8th), rehearing denied October 23, 1944; *Van Norman Co.* v. *Welch*, 141 F. 2d 99, 102 (C. C. A. 1st).

Neither *Bedford's Estate* v. *Commissioner*, 144 F. 2d 272 (C. C. A. 2d), nor the earlier decisions of the same court which are relied on here as in conflict with the decision below (Pet. 8) gave any consideration to Section 115 (h) which is dispositive of this case. The *Bedford* case was reversed on May 21, 1945, No. 710, 1944 Term.

CONCLUSION

The decision of the Circuit Court of Appeals is correct. There is no conflict of decisions and no necessity for further review by this Court. The petition for a writ of certiorari should therefore be denied.

Respectfully submitted.

HUGH B. COX,
Acting Solicitor General.
SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
J. LOUIS MONARCH,
NEWTON K. FOX,
Special Assistants to the Attorney General.

JUNE 1945.

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

* * * * *

(e) *Distributions by Corporations.*—Distributions by corporations shall be taxable to the shareholders as provided in section 115.

* * * * *

(26 U. S. C., Sec. 22.)

SEC. 27. CORPORATION DIVIDENDS PAID CREDIT.

(a) *Definition in General.*—As used in this chapter with respect to any taxable year the term "dividends paid credit" means the sum of:

* * * * *

(3) The amount, if any, by which any deficit in the accumulated earnings and profits, as of the close of the preceding taxable year (whether beginning on, before, or after January 1, 1939), exceeds the amount of the credit provided in section 26 (c) (relating to net operating losses), for such preceding taxable year (if beginning after December 31, 1937); and

* * * * *

(26 U. S. C., Sec. 27.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * * * *

(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1939, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934, 48 Stat. 712, or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

* * * * *

(26 U. S. C., Sec. 115.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.27 (a)–1. *Dividends paid credit.*—The amount of the dividends paid credit provided by section 27 (a) is an amount equivalent to the sum of the following:

(1) The basic surtax credit for the taxable year. For computation of the basic surtax credit see section 27 (b).

(2) The dividend carry-over to the taxable year. For computation of the dividend carry-over see section 27 (c).

(3) The deficit credit provided by section 27 (a) (3).

(4) Amounts used or irrevocably set aside to pay or to retire indebtedness as provided in section 27 (a) (4).

SEC. 19.27 (a)–2. *Deficit credit.*—Included in the dividends paid credit is an amount equal to the excess of any deficit in accumulated earnings and profits as of the close of the preceding taxable year (whether beginning on, before, or after January 1, 1939) over the net operating loss credit allowed by section 26 (c) for such preceding taxable year.

A deficit in accumulated earnings and profits can arise only out of the operation of the busi-

ness at a loss and cannot be caused by distributions to shareholders in excess of the amount of accumulated earnings and profits. If distributions are made to shareholders out of accumulated earnings and profits, however, such distributions may contribute to the creation of a deficit by so exhausting the accumulated earnings and profits that they are incapable of absorbing a loss thereafter resulting from the business. It is the subsequent operating loss, however, and not the distribution which creates the deficit. * * *

SEC. 19.115–11. *Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.*— * * *

The general rule provided in section 115 (b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

* * * * *

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraph (1), (2), (3), or (4) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange.* * *

U. S. GOVERNMENT PRINTING OFFICE: 1948

End